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THE SATURDAY ESSAY

China's Coming Economic Slowdown

History shows that every economic miracle eventually loses its magic. How much longer can China sustain such astounding growth?

By JOSEF JOFFE

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The big question of the 20th century has not disappeared in the 21st: Who is on the right side of history? Is it liberal democracy, with power growing from the bottom up, hedged in by free markets, the rule of law, accountability and the separation of powers? Or is it despotic centralism in the way of Stalin and Hitler, the most recent, though far less cruel, variant being the Chinese one: state capitalism plus one-party rule?

The demise of communism did not dispatch the big question; it only laid it to rest for a couple of decades. Now the spectacular rise of China and the crises of the democratic economies—bubbles and busts, overspending and astronomical debt—have disinterred what seemed safely buried in a graveyard called "The End of History," when liberal democracy would triumph everywhere. Now the dead have risen from their graves, strutting and crowing. And many in the West are asking: Isn't top-down capitalism, as practiced in the past by the Asian "dragons" (South Korea, Taiwan, Japan) and currently by China, the better road to riches and global muscle than the muddled, self-stultifying ways of liberal democracy?

Workers at the Innovation Fulfillment Center at the Foxconn factory complex in Shenzen, 2010. China's cost advantage is already plummeting; average wages have quadrupled since 2000. *Tony Law/Redux*

The Saturday Essay

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The rise-of-the-rest school assumes that tomorrow will be a remake of yesterday—that it is up, up, and away for China. Yet history bids us to be wary. Rapid growth characterized every "economic miracle" in the past. It started with Britain, the U.S. and Germany in the 19th century, and it continued with Japan, Taiwan, Korea and West Germany after World War II. But none of them managed to sustain the wondrous pace of the early decades, and all of them eventually slowed down. They all declined to a "normal" rate as youthful exuberance gave way to maturity. What is "normal"? For the U.S., the average of the three decades before the crash of 2008 was well above 3%. Germany came down from 3% to less than 2%. Japan declined from 4.5% to 1.2%.

What rises comes down and levels out as countries progress from agriculture and crafts to manufacturing and thence to a service and knowledge economy. In

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the process, the countryside empties out and no longer provides a seemingly limitless reservoir of cheap labor. As fixed investment rises, its marginal return declines, and each new unit of capital generates less output than the preceding one. This is one of the oldest laws of economics: the law of diminishing returns.

The leveling-out effect also applies to industrialized economies that emerged from a catch-up phase in the aftermath of war and destruction, as did Japan and West Germany after World War II. In either case, the pattern is the same. Think of a sharply rising plane that overshoots as it climbs skyward, then descends and straightens out into the horizontal of a normal flight pattern. The trend line, it should be stressed, is never smooth. In the shorter run, it is twisted by the ups and downs of the business cycle or by shocks from beyond the economy, such as civil strife or war.

Only hindsight reveals what has endured. In the middle of the "Surging Seventies," Japanese growth flip-flopped from 8% to below zero in the space of two years. South Korea, another wunderkind of the 1970s, gyrated between 12% and -1.5%. As the Cultural Revolution burned through China in the same decade, growth plunged from a historical onetime high of 19% to below zero. Recent Chinese history perfectly illustrates the role of "exogenous" shocks, whose ravages are far worse than those wrought by a cyclical downturn. Next to war, domestic turmoil is the most brutal brake on growth. In the first two years of the Cultural Revolution, growth shrank by eight, then by seven, percentage points. After the Tiananmen Square massacre of 1989, double-digit growth dropped to a measly 2.5% for two years in a row.

The Cultural Revolution and Tiananmen hint at a curse that may return to haunt China down the line: the stronger the state's grip, the more vulnerable the economy to political shocks. That is why the Chinese authorities obsessively look at every civic disturbance through the prism of Tiananmen, though that revolt occurred a generation ago. "Chinese leaders are haunted by the fear that their days in power are numbered," writes the China scholar Susan Shirk. "They watched with foreboding as communist governments in the Soviet Union and Eastern Europe collapsed almost overnight beginning in 1989, the same year in which massive pro-democracy protests in Beijing's Tiananmen Square and more than 100 other cities nearly toppled communist rule in China."

Today, the world is mesmerized by awesome growth in China. But why should China defy the verdict of economic history from here to eternity? No other country has escaped from this history since the Industrial Revolution unleashed the West's spectacular expansion in the middle of the 19th century.

What explains the infatuation with China? Western intellectuals of all shades have had a soft spot for strongmen. Just think of Jean-Paul Sartre's adulation of Stalin or the German professoriate's early defection to Hitler. The French Nobelist André Gide saw the "promise of salvation for mankind" embodied in Stalin's Russia.

And no wonder: These tyrants promised not only earthly redemption but also economic rebirth; they were the hands-on engineers, while thinkers dream and debate, craving power but too timorous to go for it. Too bad that the price was untold human suffering, but as Bertolt Brecht, the poet laureate of German communism, famously lectured, "First the grub, then the morals."

Harry Campbell

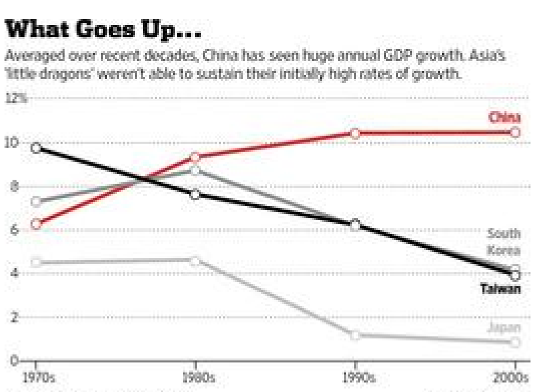
Today's declinists succumb to a similar temptation. They survey the crises of Western capitalism and look at China's 30-year miracle. Then they conclude once more that state supremacy, especially when flanked by markets and profits, can do better than liberal democracy. Power does breed growth initially, but in the longer run, it falters, as the pockmarked history of the 20th century reveals. The supreme leader does well in whipping his people into frenzied industrialization, achieving in years what took the democracies decades or centuries.

Under Hitler, the Flying Hamburger train covered the distance between Berlin and Hamburg in 138 minutes; in postwar democratic Germany, it took the railroad 66 years to match that record. The reasons are simple. The Nazis didn't have to worry about local resistance and environmental-impact statements. A German-designed maglev train now whizzes back and forth between Shanghai and the city's Pudong International Airport; at home, it was derailed by a cantankerous democracy rallying against the noise and the subsidies.

Top-down economics succeeds at first but fails later, as the Soviet model shows. Or it doesn't even reach the takeoff point, as a long list of imitators, from Gamal Abdel Nasser's Egypt to Fidel Castro's Cuba, demonstrates. Nor are 21st-century populist caudillos doing better, as Argentina, Ecuador and Venezuela illustrate.

Authoritarian or "guided" modernization plants the seeds of its own demise. The system moves mountains in its youth but eventually hardens into a mountain range itself—stony, impenetrable and immovable. It empowers vested interests that, like privileged players throughout history, first ignore and then resist change because it poses a mortal threat to their status and income.

This sort of "rent seeking" is visible in every such society. As the social scientist Francis Fukuyama explains, reflecting on the French ancien régime: "In such a society, the elites spend all of their time trying to capture public office in order to secure a rent for themselves"—that is, more riches than a free market would grant. In the French case, the "rent" was a "legal claim to a specific revenue stream that could be appropriated for private use." In other words, the game of the mighty is to convert public power into personal profit—damn markets and competition.



The French example easily extends to 20th-century East Asia, where the game was played by both state and society, be it openly or by underhanded give-and-take. Raising the banner of national advantage, the state favors industries and organized interests; in turn, these seek more power in order to gain monopolies, subsidies, tax breaks and protection so as to increase their "rents"—wealth and status above and beyond what a competitive system would deliver.

The larger the state, the richer the rents. If the state rather than the market determines economic outcomes, politics beats profitability as an allocator of resources. Licenses, building permits, capital, import barriers and anticompetitive regulations go to the state's own or to favored players, breeding corruption and inefficiency. Nor is such a system easily repaired. The state depends on its clients, just as its clients depend on their mighty benefactor. This widening web of collusion breeds either stagnation or revolt.

What can the little dragons tell us about the big one, China? The model followed by all of them is virtually the same. But some differences are glaring. One is sheer size. China will remain a heavyweight in the world economy no matter what. Another is demography. The little dragons have completed the classic course. Along that route, toilers of the land, just as in the West, thronged the cities in search of a better life. This "industrial reserve army" held down wages, driving up the profit rate and the capital stock.

And so South Korea, Taiwan and Japan turned into mighty "factories of the world," whose textiles, tools, cars and electronics threatened to overwhelm Western industry, as China's export juggernaut does today. Once it empties out, the countryside can no longer feed the industrial machine with cheap labor.

China still has many millions of people poised to leave rural poverty behind, so don't confuse it with Japan, whose shrinking and aging population won't be replenished soon by immigration or procreation. Japan ranks at the bottom of the world fertility table, one notch above Taiwan and one below South Korea. Call it East Asia's "death wish." China's "reserve army" still has a long way to go. Nor has this very poor country exhausted the classical advantages of state capitalism, such as forced capital accumulation, suppressed consumption and a cavalier disregard for the environment.

But beware the curse of 2015. Despite its rural masses yearning to go urban, China's workforce will start to decline while its legion of graying dependents keeps ballooning—the result of an abysmally low fertility rate, better health and rising life expectancy. As China gets older, America will become younger thanks to its high rates of birth and immigration. An aging society implies not only a smaller workforce but also a changing cultural balance between those who seek safety and stability and those who want to risk and acquire—traits that are the invisible drivers of economic growth.

At any rate, China's cost advantage is plummeting. Since 2000, average wages have quadrupled, and the country's once spectacular annual rate of growth no longer registers in the double digits.

Discontent there, as measured by the frequency of "public disturbances," is rising, but it is about local corruption and elite rent seeking, not about cracking the political monopoly of the Communist Party. One Tiananmen demonstration does not a revolution make. There is no shortcut to the mass-based protests that dispatched the tyrants of Taipei and Seoul.

Nor is there an imminent ballot-box revolution in China's future. It took Japan's voters a half century to dismantle the informal one-party state run by the Liberal Democratic Party, and this in a land of free elections. The Chinese Communist Party need not fear such a calamity; it is the one and only party in a land of make-believe elections.

And yet.

History does not bode well for authoritarian modernization, whether in the form of "controlled," "guided" or plain state capitalism. Either the system freezes up and then turns upon itself, devouring the seeds of spectacular growth and finally producing stagnation. (This is the Japanese "model" that began to falter 20 years before the de facto monopoly of the LDP was broken.) Or the country follows the Western route, whereby growth first spawned wealth, then a middle class, then democratization cum welfare state and slowing growth. This is the road traveled by Taiwan and South Korea—the oriental version of Westernization.

The irony is that both despotism and democracy, though for very different reasons, are incompatible with dazzling growth over the long haul. So far, China has been able to steer past either shoal. It has had rising riches without slowdown or revolt—a political miracle without precedent. The strategy is to unleash markets and to fetter politics: "make money, not trouble."

Can China continue on this path? History's verdict is not encouraging.

This essay is adapted from Mr. Joffe's "The Myth of America's Decline: Politics, Economics and A Half Century of False Prophecies," which will be published by Liveright on Nov. 4. He is the editor of Die Zeit, Germany's most widely read weekly newspaper, and a fellow of the Hoover Institution and the Freeman-Spogli Institute for International Studies at Stanford University.

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